DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 97-0146 ITC
GROSS INCOME TAX
For Years 1990 to 1993

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ISSUES

I. **Gross Income Tax – Application to out-of-state Taxpayer for sales to distributors.**

Authority: 45 IAC 1-1-120 (1)(b); IC 6-2.1-2-2 (a) 2

Taxpayer protests subjecting income from sales to distributors to Gross income tax.

II. **Gross Income Tax – Application to out-of-state Taxpayer for sales through franchisees.**

Authority: 45 IAC 1-1-120 (1)(b); 45IAC 1-1-49(1) & (2); IC 6-2.1-2-2 (a) 2; IC 6-2.1-3-3; *Tyler Pipe Industries v. Washington State Department of Revenue*, 483 U.S. 232 (1987)

Taxpayer protests subjecting income from sales through franchisee and franchisee's dealers to Gross income tax.

III. **Gross Income Tax – Application to Optional Maintenance and Warranty Contracts**

Authority: IC 6-2.1-2-2 (a) (2)

Taxpayer protests taxation of income from sales of an optional warranty and maintenance contract.

IV. **Adjusted Gross Income Tax – Royalty Income**

Authority: IC 6-3-1-20

Taxpayer protests characterizing foreign royalty income as business income.

V. Adjusted Gross Income Tax – Net Operating Losses

Authority: IC 6-3-2-2.6

Taxpayer protests the auditor's calculation of net operating losses.

VI. Gross Income Tax –Direct Sales

Authority: 45 IAC 1-1-120 (1)(b)

Taxpayer protests taxation of income from direct sales into State of Indiana.

STATEMENT OF FACTS

The taxpayer is an out of state corporation which sells residential, light commercial, and large customized heating and air conditioning systems both nationally and internationally. One special product division (hereinafter "Special division") of taxpayer's business makes direct sales into Indiana; however, the majority of taxpayer product sales within Indiana are made by two of taxpayer's product divisions. One division (hereinafter "distributor division") sells the product to distributors who in turn sell the product to independent retail dealers; the other division (hereinafter "franchise division") sells the product through franchisees and franchisees' subcontractors. Taxpayer's franchise division enters into a single contract with franchisees for the franchisees to directly or indirectly sell, install, maintain, service, and advertise taxpayer's products throughout Indiana. Franchisees and their subcontractors can also sell extended warranty and service contracts on behalf of the taxpayer with the product sales.

DISCUSSION

I. Gross Income Tax – Application to out-of-state Taxpayer for sales to distributors.

Taxpayer was assessed the tax based on IC 6-2.1-2-2(a)(2), which imposes the gross income tax on "gross income derived from activities or businesses or any other sources within Indiana by a taxpayer who is not a resident or a domiciliary of Indiana." The tax being assessed is based on the income to taxpayer from sales generated by orders to its out of state distributor division by independent distributors and shipped from various out of state assembly plants or distribution centers to the independent distributors by common or contract carrier

This activity constitutes an in-shipment of taxpayer products and is exempt from taxation under 45 IAC 1-1-120 (1) (b) *(repealed in 1998)* which states in relevant part:

(1) Nontaxable in-shipments
…..

(b) Sales made by a nonresident who has a business situs or business activities within the State, but the situs or activities are not significantly associated with the sales,

Any sales by taxpayer that originated at a taxpayer operation located in Indiana were reported by taxpayer. The remaining income is exempt.

FINDINGS

Taxpayer's protest is sustained.

II. Gross Income Tax – Application to out-of-state Taxpayer

Taxpayer was assessed the tax based on IC 6-2.1-2-2(a)(2), which imposes the gross income tax on "gross income derived from activities or businesses or any other sources within Indiana by a taxpayer who is not a resident or a domiciliary of Indiana." The tax being assessed is based on income received from the sale by taxpayer's franchise division of products manufactured out of state and installed within and outside of the state by taxpayer franchisees and/or the franchisee's subcontractors based in Indiana.

45 IAC 1-1-120(2)(a) defines an in-shipment of goods as taxable if the sales were channeled through or connected with an Indiana business situs. 45 IAC 1-1-49(1) & (2) defines a business situs as:

> … including but not limited to, the following:
> (1) Use, occupancy or operation of an office, shop, construction site, store, warehouse, factory, agency route or other place where the taxpayer's affairs are carried on;
> (2) Performance of services;

Taxpayer enters into a single contract with each of its franchisees not only for sales and delivery of its product, but also for installation, warranty repair, servicing, and advertising of taxpayer's name and product line. While taxpayer asserts the lack of an agency relationship between it and its franchisees, taxpayer fails to distinguish its sales from the performance aspects of its activities within this state. Indeed, in the franchise agreement, the taxpayer requires franchisee distributors to:

> (e) Assume full responsibility either through your own organization, an independent servicing organization, or that of your dealers, *for prompt efficient servicing, at reasonable charges to any end-user having Products installed in your area regardless of who sold or installed such Products*. In connection with this you shall cause your servicing dealers to maintain adequate repair and service shop facilities. You shall additionally have them send the appropriate personnel to schools as [taxpayer] may provide to be trained in the servicing of these Products and assume full responsibility for training service personnel of your dealers. You shall also require your dealers to maintain adequate installation and service records, specifically their customers' names and addresses, the model and

> serial numbers of equipment sold, summaries of service calls, and you shall also maintain such records for your own sales. (*Emphasis added*.)

Taxpayer's concern is not only with the delivery of products to Indiana, but, as is indicated in the italicized material, taxpayer requires its franchisees to provide ongoing product service, maintenance, advertising, and repair for any taxpayer product.

Taxpayer further asserts that the imposition of these taxes violates IC 6-2.1-3-3, which states:

> Gross income derived from commerce between the state of Indiana and either another state or foreign country is exempt from gross income tax to the extent the state of Indiana is prohibited from taxing that gross income by the United States Constitution.

The Supreme Court affirms the constitutionality of states imposing gross income taxes on out-of-state franchisers in *Tyler Pipe Industries v. Washington State Department of Revenue*, 483 U.S. 232 (1987). The facts in *Tyler* parallel the taxpayer's situation, "Tyler maintains no office, owns no property, and has no employees residing in the State of Washington. Its solicitation of business in Washington is directed by executives who maintain their offices out-of-state and by an independent contractor located in Seattle," *Tyler*, U.S. 232 at 249. The Supreme Court quoted in affirming the Washington State Supreme Court's finding that "the crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for sales," *Tyler*, U.S. 232 at 250. This standard was satisfied because the "sales representatives perform any local activities necessary for maintenance of Tyler Pipe's market and protection of its interests," *Tyler*, U.S. 232 at 251. Again, taxpayer's requirements of its franchisees and their dealers require far more than the delivery of a product, instead extending to honoring warranty relationships, servicing taxpayer products, training franchisee employees, advertising, and maintaining market sales records. The Court requirements for nexus are met.

Therefore, income derived from transactions involving the delivery of products, the performance of installation, maintenance, and warranty work, and the maintenance of trained staff and commercial locations with taxpayer's name in Indiana, represents taxable Indiana source income; however, income to taxpayer from franchises located outside of the state is not taxable.

FINDINGS

Taxpayer's protest is sustained in part and denied in part.

III. Gross Income Tax – Application to Optional Maintenance and Warranty Contracts

DISCUSSION

Taxpayer's initial argument is that the sale of optional maintenance and warranty contracts by its franchisees and franchisees' subcontractors are part of interstate sales and are thus exempt. Please refer to the second issue for an analysis of the argument.

Taxpayer was assessed the tax based on IC 6-2.1-2-2(a)(2), which imposes the gross income tax on "gross income derived from activities or businesses or any other sources within Indiana by a taxpayer who is not a resident or a domiciliary of Indiana." The tax being assessed is based on the income to taxpayer from the sale of maintenance and warranty contracts within the state by taxpayer franchisees' and the franchisees' dealers. The contracts, as noted in the Summary of Audit Report, pages 7 & 8, involve service and maintenance work by the franchisees and the franchisees' subcontractors.

Taxpayer's primary argument was based on Sales Tax Information Bulletin #2, August 1991. This states:

> Optional warranties and maintenance agreements are not subject to tax because the purchase of the warranty or maintenance agreement is the purchase of an intangible right to have the property supplied and there is no certainty that the property will be supplied. *However, if the agreement includes a charge for property to be periodically supplied, the agreement would be subject to tax.* (Emphasis added)

Taxpayer failed to address the relevance of a Sales Tax Bulletin to a Gross tax application. Additionally, as the emphasized section notes, if the warranty included a charge for property to be periodically supplied-as the taxpayer's maintenance contracts require- it was still a taxable transaction. Consequently the taxation of the agreement income stands.

Additionally, taxpayer notes that the auditor used sales data for one year to calculate the tax for the audits three years. To quote from the audit report, "Service Contract Revenue: Taxpayer supplied the 1993 amount and requested that it be used for the period 1990-92." Inasmuch as the amount in question was mutually agreed on during the audit, there is no question of law presented and no change is required.

FINDINGS

Taxpayer's protest is denied.

IV. Gross Income Tax – Royalty Income

DISCUSSION

Taxpayer is engaged in international marketing of its products. For various cultural reasons, taxpayer alters its name and product to fit the overseas market. Taxpayer argues that these changes alter the nature of its business enough to remove the overseas income from the definition of business income found in IC 6-3-1-20, which states:

> Sec. 20 The term "business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations.

All royalties in question arise from international transactions within taxpayer's trade. As taxpayer notes in their appeal, their domestic trademark includes a "specific reference to 'American' [which] has been found to be sensitive in other countries," and "differentiated national markets reflect disparate local architectural preferences, construction regulations and especially the very different cultural attitudes in matters of personal hygiene." Thus, aside from these accommodations for foreign sensibilities, these activities are within the purview of taxpayer's trade and business operations.

Taxpayer does note that a different subsidiary exists that has no similar domestic U.S. product line. Inasmuch as the wholly owned subsidiary still consists of taxpayer managed tangible and intangible property; the auditor's conclusion that it was integral to taxpayer's trade and business operations will stand.

FINDINGS

Taxpayer's protest is denied.

V. Gross Income Tax -Net Operating Losses

DISCUSSION

Taxpayer asserts that IC 6-3-2-2.6(b) requires its net operating losses be increased by its recognized nonbusiness income and its foreign source dividend deduction. Taxpayer agrees that the auditor's initial calculation of the net operating loss amounts was correct as required by IC 6-3-2-2.6(b), but objects to auditor's refusal to add the foreign source dividends to the net operating loss denominator.

IC § 6-3-2-2.6 allows domestic dividends received to be included in the net operating loss base by reference to Internal Revenue Code Sec: 172, but the statute does not include foreign source dividends in the net operating loss base. IC 6-3-2-2.6(a) requires a four- (4) step process to calculate the net operating loss. Step 2 requires the calculations from IC 6-3-2-2.6(b) used by both the auditor and taxpayer to calculate a net operating loss amount. Step 3 requires; "Enter the larger of zero (0) or the amount determined under STEP TWO. Inasmuch as the totals from step 2 are negative numbers, zero (0) is larger and was thus entered by the auditor, computationally reflecting the omission of the foreign source dividend loss by the statute's exclusive use of IRS Code Sec: 172 for the net operating loss base calculation.

Taxpayer also noted a possible conflict with IC 6-2.1-3-3, which applies to Constitutional exemptions from gross income tax and the Foreign Commerce Clause of the U.S. Constitution. The gross income tax issue was addressed under the discussion of Issue II, please refer to the analysis related to it. The Foreign Commerce Clause deals with improper assessment of taxes, not the calculation of net operating losses; accordingly, it is not controlling on this issue.

FINDINGS

Taxpayer's protest is denied.

VI. Gross Income Tax –Direct Sales

DISCUSSION

Taxpayer asserts that the auditor erroneously picked up sales as taxable because he confused the acronym "RPG" with "UPG" and identified sales from an out-of-state office to Indiana customers as taxable for gross income tax purposes. The sales from an out-of-state office to Indiana customers constitute an in-shipment of taxpayer products and would be exempt from taxation under 45 IAC 1-1-120 (1)(b), which states in relevant part:

(1) Nontaxable in-shipments
…..
(b) Sales made by a nonresident who has a business situs or business activities within the State, but the situs or activities are not significantly associated with the sales.

FINDINGS

Taxpayer's protest is sustained.

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